

Revenue recognition (Lecture A877/ A878/ A879 – 12.58/ 19.52/ 20.31 minutes)

There has been lots written in the professional press concerning the Financial Reporting Council's (FRC) periodic review of UK and Ireland accounting standards. In quarter 3, we examined the new lease accounting provisions and this quarter we will take a high-level look at the new revenue recognition treatments.

The periodic review amendments come into mandatory effect for accounting periods commencing on or after 1 January 2026, with early adoption permitted, provided all the periodic review amendments are applied at the same time.

In September 2024, the FRC issued new editions of UK and Ireland accounting standards which incorporate the periodic review amendments. It should be noted that where an entity has chosen **not** to early adopt the periodic review amendments, the provisions in the January/November 2022 editions continue to apply until accounting periods commencing on or after 1 January 2026.

FRS 102 (September 2024) also contains specific disclosure requirements in the statement of cash flows in respect of supplier financing arrangements. These additional disclosures become mandatorily effective for accounting periods commencing on or after 1 January 2025 with early adoption permissible.

Revenue recognition under FRS 102 and FRS 105 (September 2024)

The new revenue recognition rules affect both FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*.

Both FRS 102, Section 23 and FRS 105, Section 18 have a new title *Revenue from Contracts with Customers* (which is consistent with IFRS[®] 15 *Revenue from Contracts with Customers*).

Included within both sections is a five-step comprehensive model for recognising revenue. FRS 102, para 23.4 clarifies the objective of the model is for an entity to recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration an entity expects to be entitled in exchange for those goods and/or services.

The five-step model approach to recognising revenue works as follows:



Step 1: Identify the contract(s) with a customer

FRS 102, para 23.7 sets out specific criteria, all of which must be met, to account for a contract with a customer. These criteria are as follows:

- (a) the parties to the contract have approved the contract and are committed to perform their respective obligations;
- (b) the entity can identify each party's rights regarding the goods or services to be transferred;
- (c) the entity can identify the payment terms for the goods or services to be transferred;
- (d) the contract has commercial substance; and
- (e) it is probable (i.e. more likely than not) that the customer will have the ability and intention to pay the consideration to which the entity will be entitled when it is due.

Example – Identifying a contract with a customer

The principal activity of Salinger Ltd is that of an IT services provider. One of its many services is providing support and repair services via the internet and onsite to both corporate customers and the general public.

Salinger Ltd enters into a contract with a new customer to scan its server for viruses and to clean up redundant files. An IT consultant has agreed a price with the customer by telephone. As the customer is new, and does not have credit facilities, the IT consultant took payment for the work over the telephone.

The services will be carried out by Salinger Ltd in the next week once the customer's premises are closed (to avoid any disruption during working hours). Salinger will be able to login to the customer's server and carry out the necessary work.

Salinger Ltd and its customer have entered into an oral contract. A contract need not be in writing for it to be enforceable (the three elements to a contract are: 'offer', 'acceptance' and 'consideration', all of which have been provided). The customer has provided payment details and consideration for the services to be provided, hence Salinger is committed to performing the work on the customer's server.

In this situation, all the criteria in FRS 102, para 23.7 are met and the contract is within scope of FRS 102,

Step 2: Identify the performance obligations in the contract

A 'performance obligation' is defined as:

*A promise in a **contract** with a **customer** to transfer to the customer either:*

- (a) a distinct good or service (or a distinct bundle of goods or services); or*
- (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.*

Some contracts contain more than one performance obligation. For example, a client could sell an item of machinery to a customer and provide one year's servicing and maintenance. Similarly, a course provider might enter into a contract to provide five lectures at various different times and a textbook either on the first day of the course, or on receipt of payment or initial registration.

Example – Identifying performance obligations in a contract

Harper Ltd is a bookkeeping software developer. It enters into a three-year contract with its customer to provide a licence to access the bookkeeping software. The contract stipulates that Harper will provide periodic software updates and technical support throughout the duration of the contract.

The bookkeeping software is delivered electronically prior to installation, updates and technical support and is functional without the updates and/or technical support. This means the customer benefits from each good or service individually. Harper has also determined that the licence, installation, updates and technical support are all separately identifiable. Hence, in this scenario there are four performance obligations in the one contract:

- The licence to supply bookkeeping software
- The installation service
- Updates to the software
- Technical support

Step 3: Determine the transaction price

There are various sub-components in determining the transaction price and FRS 102, paras 23.43 to 23.64 cover the following issues:

Variable consideration	Paras 23.43 to 23.47
Sale-based or usage-based royalties	Para 23.48
Refund liabilities	Paras 23.49 to 23.50

Sale with a right of return	Paras 23.51 to 23.57
Time value of money	Paras 23.58 to 23.60
Non-cash consideration	Para 23.61
Consideration payable to a customer	Paras 23.62 to 23.64

The transaction price is the amount of consideration the entity expects in exchange for satisfying a performance obligation.

Example – Determining the transaction price with variable consideration

Sunnie Industries Ltd enters into 30 contracts with its customers to supply various chemicals. Each contract includes the sale of one type of chemical with a selling price of £1,200. The cost to Sunnie Industries of each of these types of chemicals is £700. Customers can return the products within 30 days for a full credit and any returned goods can be used in other chemical mixes or sold again at a profit.

The finance director can reliably estimate the return rate for this type of chemical based on previous experience. On this basis, the finance director has estimated that 26 products will not be returned, meaning four are likely to be returned.

As the customers can return the products, the consideration is variable. FRS 102, para 23.44 requires any of the following to be used when estimating variable consideration:

- the expected value method; or
- the most likely amount method.

Using the expected value method, the estimated variable consideration is £31,200 (26 products x £1,200). The variable consideration is included in the transaction price because, based on previous experience, it is highly probable that Sunnie Industries will be entitled to the cumulative amount of revenue recognised (£31,200) when the uncertainty associated with the variable consideration is subsequently resolved (FRS 102, para 23.46).

Revenue of £31,200 and a refund liability of £4,800 (4 products expected to be returned x £1,200) is recognised (FRS 102, paras 23.53(a) and (b)).

In addition, Sunnie Industries must derecognise the stock transferred to its customers. It will also recognise a refund asset (classified as stock) of £2,800 (4 products x £700) as well as a corresponding credit to cost of sales. This represents the entity's right to recover products from customers on settling the refund liability (FRS 102, para 23.53(c)).

Step 4: Allocate the transaction price

FRS 102, para 23.65 requires the entity to allocate the transaction price to each performance obligation identified on a relative stand-alone selling price basis, unless allocating discounts or variable amounts on an alternative basis.

Where a customer is offered a discount for purchasing a bundle of goods and services, the discount is allocated across all performance obligations within the contract in proportion to their stand-alone selling prices, unless observable evidence suggests this would be inaccurate.

Example – Allocating the transaction price with a discount

Lemming Industries Ltd sells an industrial cutting machine with one year's free technical support for £100,000. The sale of the machine and the technical support have both been identified as separate performance obligations.

On a stand-alone basis, the machine would sell for £95,000. This is the first time Lemming has started to provide technical support for this type of machine. Other support services provided by Sunnie (all of which generate a profit), attract a markup of 50%. It is expected that the technical support service will

cost £20,000.

The selling price of the machine on a stand-alone basis is £95,000 but there is no observable selling price for the provision of technical support. FRS 102, para 23.69 requires the stand-alone selling price to be estimated. FRS 102, para 23.70 suggests the following suitable methods:

- (a) an adjusted market assessment approach;
- (b) expected cost plus a margin approach; or
- (c) residual approach.

The residual approach would attribute £5,000 (£100,000 - £95,000) to the technical support service. This does not, however, approximate the stand-alone selling price of similar technical support services, which generate a profit for the entity.

A more appropriate approach would be an expected cost plus a margin approach. Based on this approach, the selling price of the technical support service would be £30,000 (£20,000 x 150%).

The total of the stand-alone selling prices of the machine and technical support is £125,000 (£95,000 + £30,000). However, the total consideration is only £100,000. This means the customer is receiving a discount for purchasing a bundle of goods and services of 20% (£25,000 / £125,000).

FRS 102, para 23.74 assumes that discounts relate to all performance obligations within a contract unless this basis does not depict the amount of consideration to which the entity expects to be entitled (in which case the entity uses a method that does reflect such amounts).

The transaction price allocated to the machine is £76,000 (£95,000 x 80%).

The transaction price allocated to the technical support is £24,000 (£30,000 x 80%).

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognised when (or as) the entity satisfies a performance obligation by transferring a good or service to a customer. A performance obligation is said to be satisfied **over time** if one of the following criteria in FRS 102, para 23.81 (a) to (c) are met:

- (a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- (b) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- (c) The entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Example – Provision of payroll services

Paul's Payroll Services enters into a contract with Wolves Ltd to provide monthly payroll services at a contracted rate of £16,000 per annum. Paul's Payroll Services has a year end of 30 June 2024.

The provision of payroll is a separate performance obligation which is performed over time. This is because the customer simultaneously receives and consumes the benefit of the payroll service. Even if

Wolves Ltd were to change payroll provider, the payroll would not need to be reperformed.

Paul's Payroll Services recognises revenue from the service over time. Hence, in the year to 30 June 2024, the entity recognises £8,000 as revenue (£16,000 x 6/12).

FRS 102, para 23.102 refers to 'output methods' (e.g. surveys of performance) and 'input methods' (e.g. costs incurred as a proportion of total expected costs) for measuring progress towards the satisfaction of a performance obligation.

If the progress cannot be reliably measured, revenue is only recognised up to the recoverable costs incurred.

Example – Construction contract

On 3 January 2026, Dwyer Ltd enters into a contract with Whitaker Ltd to construct a new building for £8 million plus a bonus of £1 million if the building is completed within 18 months. Estimated costs to construct the building have been calculated at £6 million.

The winter months are renowned for causing delays to construction and sourcing various materials can also be problematic at times which can contribute to delays in construction. Hence, Dwyer is uncertain whether the bonus will be received.

At the year end 31 December 2026, Dwyer is still uncertain whether its bonus target will be achieved due to other delays during the year, such as staffing issues and breakdowns of machinery. Dwyer decides to measure progress towards completion based on costs incurred (FRS 102, para 23.102(e)). Costs incurred on the contract to date are £2 million.

The construction of the building is a single performance obligation. The bonus element is variable consideration and must be excluded from the transaction price because it is not highly probable that it will be entitled to the cumulative amount of revenue (FRS 102, para 23.46).

The construction is accounted for as an obligation performed over time. Dwyer should recognise revenue based on progress towards satisfaction of the construction of the building. Using the costs incurred approach, the performance obligation is 1/3 (£2.0m / £6.0m) complete.

Accordingly, revenue and costs recognised at the year end are:

		£m
Revenue	(£8m x 1/3)	2.6
Costs	(£6m x 1/3)	(2.0)
Gross profit		<u>0.6</u>

Practical implications

The new revenue recognition requirements in FRS 102, Section 23 and FRS 105, Section 18 are completely new, and, in some cases, these new requirements may result in different revenue profiles than under the 2022 editions of the standards. Keep in mind there are new

prescriptive requirements for transactions involving (among other things) non-refundable upfront fees and income arising from licensing and royalties.